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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 132

MARGARET L. HOLT and KATHLEEN L. McMAHON, individually and on behalf of all other shareholders of Alleghany Corporation similarly situated,
Petitioners,

—against—

ALLAN P. KIRBY, CHARLES T. IRELAND, JR., FRED M. KIRBY and ALLEGHANY CORPORATION,

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONERS

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This brief replies to Brief of Respondent Allan P. Kirby. No written reply is made to Brief of Respondent Fred M. Kirby or Brief of Respondent Charles T. Ireland.

ARGUMENT

Petitioners' position is a simple one: The IDS stock was illegally taken from Alleghany and justice requires that it, or its equivalent value, be returned. The prior fraudulent settlement in a state court of a claim based on that wrongful taking does not prevent a federal court from reaching that just result.

Heretofore, respondent has been content to argue, in the main, that the state court settlement prevented a federal court from remedying what we contend, and the Court of Appeals unanimously agreed, was a blatantly illegal act. Those arguments are now repeated, but respondent has also expanded his argument and now contends that the return of his IDS shares would *not* be a just result.

In order to make both of these arguments, respondent has rewritten the case and misstated petitioners' contentions. He has in fact argued different issues than those before this Court. The purpose of this reply is:

1. To restate the genuine issues before this Court.

2. To point out the respondent's major distortions of these issues, and

3. To show that without these distortions it is impossible to argue either: (a) that a just result does not require the return of IDS stock, or (b) that a state court settlement prevents a federal court from doing what justice requires.

Petitioners' Contentions and The Genuine Issues

The petitioners' contentions are as follows: The IDS stock was wrongfully taken and the proxy material seeking approval of that transaction was false and misleading in violation of § 14(a). The settlement attacked here disposed of claims arising out of that transaction and based on § 14(a). Concealments by Young and Purcell of documents relevant to a fair evaluation of those claims were a fraud when those concealments are tested by proper federal standards. Kirby as a co-fiduciary and co-conspirator of Young and Purcell cannot keep the benefits achieved by the conspiracy and preserved by the fraud of his co-conspirators.

These contentions raise only the following issues:

(1) Should directors disposing of a derivative claim against them based upon violations of § 14(a) of the Securities Exchange Act of 1934 be held to a duty of disclosure consistent with the policy of that statute? (Petitioners' Brief pp. 26-30)

(2) If so, does violation of that duty of disclosure vitiate the settlement? (Petitioners' Brief pp. 30-34)

(3) What is the proper legal standard for determining whether the concealments of Young and Purcell constitute a fraud? (Petitioners' Brief pp. 34-38)

(4) Is Kirby liable for the fraud of his co-fiduciaries Young and Purcell? (Petitioners' Brief pp. 41-44)

(5) Is the federal court barred from applying the correct federal standards because the settlement under attack was approved by a state court? (Petitioners' Brief pp. 44-50)

Respondent's Argument and The Underlying Distortions

Before we turn to an analysis of the eight points of respondent's argument and the distortions upon which they are based, we deal briefly with two points: (a) the insurmountable difficulty Kirby has in contending that it would be unjust, under any circumstances, to require him to return his IDS shares, and (b) his confusion of the cause of this lawsuit with its merits.

(a) Key to the first contention is the argument that the taking of the shares as well as the related proxy material was legal, and that the Referee was right in so holding. But, that argument is unsupportable in view of the existence of the inside information discovered in this suit

and the unanimous opinion of the Second Circuit that the taking of the IDS shares and the proxy material which sought its approval were plainly illegal. Proof that respondent has no way around those hard facts is found in the explanation he offers for the Court's unanimity. That explanation consists of a reference to a "hydraulic effect", as if that effect were an established legal doctrine, or at least a recognized judicial phenomenon (Res. Br. p. 75).

Not one of the eight judges believed the 1950 IDS transaction and the related proxy material were anything but blatantly illegal. Since respondent's argument cannot be constructed unless this uniformity is explained away, he offers as an explanation that the entire Second Circuit was "hydraulicized".

We invite this Court to take a bone-dry look at the record, to examine the documents and information in the possession of the insiders, including that which was withheld during the settlement proceedings. Can there be any doubt that Judge Friendly was correct when he asked: if the record before the Referee had been supplemented by proof that at the time of the exchange Purcell and Young knew IDS was forecasting even higher earnings, could any "rational mind" have concluded that the IDS exchange was not illegal (R. 2366)? We suggest that Judge Friendly's colleagues on the Second Circuit reached the same conclusion because they too were "rational" men, not because, as respondent suggests, the entire Second Circuit simultaneously took flight from their "normally exact craftsmanship" (Res. Br. p. 75).

(b) It is apparent from the analysis below, that respondent has, in large part, chosen to argue issues other than those before this Court. Moreover, he is plainly frustrated by not having escaped the necessity of arguing any case at all. In his view, except for two fortuitous circum-

stances, the IDS stock would now rest securely in his portfolio and his possession would be unchallenged. Those two circumstances are: the dramatic rise in the IDS stock and the falling out between respondent and the Murchisons. Throughout his brief there is the echo of an anguished lament: "This case might never have been . . . . *if only* the IDS stock had not dramatically risen . . . *if only* the Murchisons had not fallen out with Kirby." In respondent's view, except for the former the original claim would never have been asserted; and except for the latter this suit would never have been started.

Whether he is right or wrong is beside the point. Whether the illegal IDS transaction would have been discovered if not for the dramatic rise in the price of that stock, and whether the fraudulent settlement of the claim based upon that transaction was the cause, or the effect, of the falling out between Kirby and the Murchisons is immaterial. The fraud has been exposed. The case is here. Let us get on with it.

The shareholders, who are petitioners here, are not looking a gift horse in the mouth, nor, we are certain, are the minority shareholders of Alleghany whom they represent. They welcome the opportunity, however it came about, to regain for Alleghany what was illegally taken.

Nor should this Court be concerned with how suits get started, unless, of course, there is a claim of unclean hands. No such claim exists here, or can be made. The shareholders for whose benefit this suit is brought are not barred by any principle of equity from asserting the claim here.

Respondent makes repeated references to the two events, stated in one form or another, which he believes has caused his predicament; he terms them "crucial" and, indeed, he makes them crucial to his argument (Res. Br. p. 72). But, he does so by confusing the causes of the suit

with its legal basis. It is the latter which determines recovery—not the former.

Respondent chides petitioners' predecessors for not bringing this action in the state court, where, he advises us, it would have been easier to set his settlement aside. Whether he is right or wrong is beside the point. The federal court was and is a proper forum for this plenary action to set aside the fraudulently procured settlement whether it was obtained in both the federal and state courts or from the state court alone. *Marshall* v. *Holmes,* 141 U. S. 589 (1891); *Griffith* v. *Bank of New York,* 147 F. 2d 899 (2nd Cir.), cert. denied 325 U. S. 874 (1945). Indeed, when an attempt was made in state court, by way of a motion in *Zenn*, state, to set aside the *Zenn* judgment, Justice McGivern denied the application explicitly deferring to this suit. He stated that a plenary action was the proper way to attack the settlement for fraud. *Zenn* v. *Anzalone,* N. Y. L. J. p. 10, col. 6 (December 30, 1960) Sup. Ct. N. Y. Co.

Since the action is properly brought in federal court, respondent's complaint that it could also have been brought in state court is irrelevant.

Nor is there any merit (or any legal significance) in his contention that the reason the suit was brought in federal court was fear that the state court might set aside the Murchison settlement. That settlement in no way related to the claims fraudulently settled. If Kirby believes that the Murchison settlement was procured by fraud, nothing has prevented him or Alleghany from bringing an action to set that settlement aside. No such action has been brought, because there is no basis for the implication in respondent's brief that apprehension about an examination of that settlement dictated the choice of the federal court. Nor is there any mystery about that choice. This is an action for fraud

and petitioners' predecessors wanted and needed the more liberal discovery procedures found in the federal rules.

Following, is an analysis of each of respondent's points and of the distorted issues which form their base:

1. IN REPLY TO RESPONDENT'S POINT I

Respondent's Point I is devoted entirely to the proposition that no personal dereliction on Kirby's part has been shown.

He erroneously assumes that petitioners' case requires a showing of personal dereliction on Kirby's part (Res. Br. p. 79 et seq. especially pp. 83-84).

Petitioners do not, and their counsel have never, so urged. While it was argued below that there was personal dereliction on Kirby's part, it has never been contended or conceded that Kirby's own failure to produce was the only ground for depriving him of the benefits of the settlement. Respondent and the trial court—not plaintiffs—took that limited view, and it is the issue that respondent would like to argue here. The record does not allow him to do so. Three grounds were put forth below for holding Kirby liable: (1) Kirby was personally responsible for withholding inside information which he had in his possession, (2) Kirby was personally responsible for withholding inside information which he should have known existed, and (3) Kirby was responsible for the concealment of his co-fiduciaries and co-conspirators, Young and Purcell. While it is true that in the trial court more emphasis was placed on the first two theories than on the third, the acceptance of any one of them would have been sufficient to yield the result urged and is sufficient to support reversal. Judge Friendly found that while grounds (1) and (2) had not been established, evidence, excluded by the trial judge, established ground (3). But that did not keep Judge Friendly

from deciding for plaintiff below. He concluded that Kirby should not be allowed to keep the fruits of a settlement fraudulently procured by his co-fiduciaries. In our subsequent briefs to the Court of Appeals *en banc* and on our briefs to this Court we have relied exclusively upon Judge Friendly's view of the case.

We do not, however, accept respondent's subtle transformation of the conclusion that there was no actual fraud on the part of Kirby during the settlement proceedings, into a finding that Kirby was innocent and acted in good faith from start to finish. Failure to prove that Kirby personally committed a fraud during the settlement proceedings does not amount to a showing that Kirby acted in good faith during those proceedings and it certainly does not establish his innocence in regard to the 1950 IDS stock transaction (See e.g. Petitioners' Brief pp. 4-6, 42).

2. IN REPLY TO RESPONDENT'S POINT II

Respondent erroneously states, as the basis for his Point II, that petitioners' counsel has disclaimed that Kirby was responsible for acts of Young and Purcell (p. 83) and, at a later point in his brief, that petitioners' position in this regard is not the same as that of Judge Friendly (p. 164).

Petitioners, or their predecessors, have never disclaimed Kirby's liability for the fraud of his co-fiduciaries and co-conspirators. On the contrary, the issue has been continually argued and briefed; it has always been in the case.*

In the trial court, Kirby emphasized his dependence upon Young and Purcell. In defending the fairness of the settlement, he was quick to stand upon their disclosures to the Referee. Thus, he argued that Alleghany's, as well as Young's and Purcell's, files were opened to inspection (Tr.

*There are, in fact, no new issues and no new facts argued here. A director's duty to disclose and the consequences of that duty have always been in issue. The arguments in petitioners' brief are properly before this Court. See 66 Col. Law R. 386, 388-389 (1966).

974) and he ultimately obtained a ruling from the trial court that he was under no obligation to "me too" the facts thus put before the Referee (Tr. 1901). This dependence upon the documents produced and testimony given by Young and Purcell was argued at length in Kirby's Post-Trial Brief (pp. 62-7). Kirby may not "me too" the disclosures of Young and Purcell in one breath and, in the next breath, deny the consequences of their non-disclosures and concealments. Moreover, Kirby is trying to protect himself by invoking the *Zenn* settlement as res judicata in the present action, therefore, "he has no justification for claiming the non-disclosures of his cohorts in *Zenn* should not be used to defeat his claim . . ." 74 Yale L. J. 1140 N 6 (1965).

In any event, at trial there were repeated attempts to charge Kirby with the consequences attaching to the knowledge and behavior of his co-fiduciaries. Thus, documents conceded to be in Alleghany's files or those of Purcell were offered as evidence against Kirby on the basis:

> "that Mr. Kirby quite independently of what he personally knew as a director and as president of Alleghany could not delegate his responsibility to be a director and to be the president of Alleghany . . ." (R. 681).

> "[I]n our view Mr. Kirby cannot be saying now that he left this to Robert Young or he left this to Mr. Purcell [and he cannot] escape the consequences in a situation where he wants to hold on to property that he got from Alleghany's own securities portfolio" (R. 697).

And,

> "[Kirby] cannot by being inactive or by tendering his job over to Mr. Young escape liability in connection with a self-dealing transaction where he took stock from Alleghany's portfolio" (R. 699).

The failure of Young and Purcell as well as Kirby to disclose evidence was repeatedly argued in Plaintiff's Post Trial Brief.*

And, in examining Purcell, the following colloquy occurred in the course of counsel's efforts to introduce evidence as to Purcell's concealments over the trial judge's insistence that evidence not "tied" to Kirby would not be admissible (R. 544):

> The Court: "He said he got many reports. Your case involves certain reports which you said Mr. Kirby had which Alleghany Corporation did not have. Why not get to these issues. Here you have a lot of reports going to a man in Alleghany Corporation. Why not go to the case and prove that Mr.

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*"Plaintiff contends that Kirby *and his co-defendants* in *Zenn* (State) not only failed to adduce material evidence 'concerning earning developments of IDS which reflected a trend to further improvements and an increase in market value foreseeable and foreseen' by them, but submitted to the Referee documents and oral testimony relating to their 'substantial defenses' which largely served to mislead the Referee with respect to the fairness of the transaction and hence the fairness of the settlement itself" (Plaintiff's Post-Trial Brief, at 123-24).

And again,

> "The repeated demands in *Zenn* for documents bearing on the 1950 exchange transaction and the non-compliance therewith serve, however, to emphasize the extent of the breach of duty by Kirby *and his co-defendants.*
>
> * * *
>
> "The evasion and 'run-around' given to the objectant's counsel by Kirby's representative [204-a] Wallace, *Kirby's co-defendants* and their attorneys is appalling in light of what we now know as to the existence and availability of critically important records" (*Id.*, at 126-27).
>
> * * *

And again,

> "It was not for Kirby *and his co-defendants* to pick and choose which documents and what information they would permit the Referee to have. They were under a duty to disclose all material information bearing on the transaction" (*Id.*, at 146).

Kirby had reports which this man did not have. Mr. Updike: "Our case is broader than that."

The breadth of the case was explained in a subsequent statement quoted by Judge Friendly:

> Mr. Updike: "Well, it seems to me sir, that if Mr. Kirby entrusts the responsibility to some extent of his being a director of Alleghany, if he entrusts some of that responsibility to Mr. Young, then Mr. Kirby cannot avoid accepting the consequences of whatever Mr. Young may have done, and I do not say that it was Mr. Young and I do not say for a moment that it was Mr. Purcell, and I do not know who is responsible." (R. 606)

Respondent lays great stress on counsel's unwillingness, in the last line or two of the quotation, to designate which of the three culprits was actually responsible for the particular concealment then under discussion. But, that unwillingness is in no way inconsistent with the contention—clearly set forth in the rest of the quotation—that it did not matter which of the three co-fiduciaries actually did the dirty work; none should be allowed to keep the fruits.

Even if the argument had not been raised at trial, it was properly before the Court of Appeals and, hence, is properly before this Court because the issue clearly falls within two of the well-recognized exceptions of the first-time-on-appeal rule relied on by respondent:

(1) The general rule applies only to a new issue, not to a new theory or argument on the same issue. Even if Kirby's responsibility for fiduciary non-disclosure had been argued at trial principally on a *direct,* personal basis below, and is here argued also on an indirect co-fiduciary—co-conspirator basis, the basic issue herein has always been whether Kirby shall be held entitled to retain the benefits

of a fraudulently obtained settlement. As was said in *Chase Nat'l Bank* v. *United States,* 116 F. 2d 625, 628 (2d Cir. 1940), the appellant is "now simply giving new reasons to show that [the same ground] is applicable. It is quite impossible to suppose that a new reason for the application of [the ground] always relied on may not be considered by this court." *Accord: Bates Valve Bag Corp.* v. *Higgins,* 157 F. 2d 886, 887 (2d Cir. 1946). Cf., *Massachusetts Bonding & Ins. Co.* v. *New York,* 259 F. 2d 33, 40 (2d Cir. 1958).

Whatever the principal theory may have been at trial, whatever statements may have been made by trial counsel, whatever respondent and the trial court conceived the issue to be, it is beyond question that the record before the Court of Appeals contained sufficient evidence of Young's and Purcell's concealments and Kirby's connections with and reliance upon them to have allowed that Court to consider the issue of co-fiduciary liability. Hence, the issue is properly before this Court.

(2) Moreover, the precise question which the co-fiduciary argument raises is an issue of law, and this, in and of itself, is enough to remove this case from the scope of the general rule. As was stated in *Foster* v. *United States,* 329 F. 2d 717 (2d Cir. 1964), "These contentions are wholly different from the points raised in the court below, but since only a question of law is involved, we will proceed to consider them". Cf., *Mulligan* v. *Andrews,* 211 F. 2d 28, 29 (D. C. Cir. 1954).

Nor is there any warrant for respondent's contention (p. 164) that petitioners' position is not that of Judge Friendly. The attempt to draw a distinction between petitioners' position and that of Judge Friendly rests on the erroneous assumption repeated throughout respondent's

brief, that petitioners urge a rule that would require Kirby to ferret out information. They urge no such rule, and on the facts of this case, no such rule is required.

3. IN REPLY TO RESPONDENT'S POINT III

Respondent's Point III does address itself to one of the issues in this case, namely, can Kirby keep the benefit of a settlement fraudulently procured by his co-fiduciaries. The factual and legal basis for the argument that the settlement is no more valid merely because the fraud was committed not by Kirby but by his co-fiduciaries is found at pp. 41 to 44 of petitioners' brief and in Judge Friendly's dissent (R. 2351-2352). Respondent does not successfully meet that argument. Instead, he relies on the premise that Kirby is *entirely* "innocent". The suggestion that Kirby is innocent insofar as his participation in the IDS exchange transaction is baseless, nor can it be said that Kirby's behavior during the entire course of the settlement proceedings was one manifesting either innocence or good faith (Petitioners' Brief pp. 4-6, 42).

Respondent also relies heavily on *Taxin* v. *Food Fair Stores, Inc.*, 287 F. 2d 448 (3d Cir.), cert. denied 366 U. S. 930 (1961), stating that it involves "precisely the same question" we are faced with here (Res. Br. p. 108). But, *Taxin* is a case involving two separate conspiracies (287 F. 2d at 451) and this case does not. In *Taxin*, the court saw no connection between a conspiracy to violate the antitrust laws and one to fraudulently procure a release. It held that the "release conspiracy" (being unknown to some defendants and not within the "reasonable intendment or the common understanding" of the original antitrust conspiracy) was not part of antitrust conspiracy (287 F. 2d at 451). Here the evidence plainly shows that the very essence of the 1950 conspiracy was a common under-

standing among Kirby, Young and Purcell to take Alleghany's investment in IDS for themselves by concealing inside information from Alleghany's shareholders. That concealment was an essential element of the 1950 conspiracy; without it shareholder approval could not be obtained. When some shareholders objected and sued, the same concealment continued. In essence, those suits merely postponed complete shareholder approval until they were ended in the settlement which was obtained by a continuation of the earlier concealments.

There is, therefore, no factual break in the chain of joint conduct: Kirby, Young and Purcell perpetrated the illegal transaction jointly, were sued jointly in derivative actions seeking to redress the illegal transaction, and stipulated jointly for a single sum to be paid in settlement of all claims (R.729). They literally stuck together throughout. Consequently, Kirby has no factual basis for putting the 1950 unlawful transaction in one compartment and the 1955 breaches of duty in settling claims arising therefrom in another.

Kirby cites no legal authority for severing his original joint participation in the IDS stock transaction from the joint settlement of the claims arising therefrom. The law is to the contrary, see *Gerdes* v. *Reynolds,* 30 N. Y. S. 2d 755, 773 (Sup. Ct. N. Y. Co. 1941), which held that a director who embarks upon a joint breach of fiduciary duty is liable for the subsequent acts of those who participated with him, even though the subsequent acts were unforeseen at the beginning and were independently wrong.

In addition, unlike the defendants in *Taxin,* Kirby, Young and Purcell were all proponents of a joint settlement.* Also unlike *Taxin,* judicial approval of the fairness

*We cannot see how the fact that individual stipulations of settlement were entered into by the defendants alters this fact. It certainly does not bring the case under the rule in *Taxin.* Nor does the fact

and inadequacy of the joint settlement was necessary and was procured by fraudulent concealments by two of the joint proponents of the settlement. Accordingly, we see no basis in logic, in conscience, or in *Taxin* for permitting Kirby to retain the benefits of such judicial approval where it was fraudulently obtained by his partners. Certainly the innocent defendant in *Taxin,* unlike Kirby here, was in no way seeking to take advantage of the fraud of its co-conspirator.

Lastly, *Taxin* in no way touches upon the co-fiduciary rule of *Jackson* v. *Smith,* 254 U. S. 586 (1921), which is directly applicable here. Kirby was a knowing joint participant in the original breach of trust and remained so throughout all of the prior proceedings.

We submit that Kirby may not retain the benefit of a settlement tainted by the fraud of his co-fiduciaries, co-conspirators. As Judge Kaufman stated (R. 2347-2348):

> "In terms of its reliability as a fair and genuine adjudication of the adequacy of the settlement, the referee's approval would seem to stand on no firmer grounds merely because the fraud which kept material documents from the attention of the Zenn plaintiffs may not be directly imputed to Kirby."

4. IN REPLY TO RESPONDENT'S POINT IV

Respondent argues in Point IV: (a) that the documents in question were made available by Young and Purcell and (b) in any event, they were "cumulative."

(a) The first of these propositions is flatly contradicted by the record. Respondent's argument is based, first, on the false statement that "petitioners' counsel has admitted

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that Kirby succeeded in negotiating a settlement of his own liability in December 1959, and that this displeased Young's widow, insulate Kirby from the earlier acts of his co-fiduciaries.

that there is nothing to show that the 'concealed' documents were not made available" to the shareholders' counsel and, second, on the truncated testimony of Graubard (Res. Br. p. 116, 123).

Petitioners' counsel has never conceded that there is "nothing to show" that the concealed documents were not in fact made available to the shareholders' counsel in *Zenn*. We have strenuously argued throughout that it can only be concluded from the record below and the record in *Zenn* that these documents were not produced.. Indeed, the record reference cited by respondent for this proposition is plaintiff's answer to defendant's Interrogatory V, which specifically states that the documents claimed to have been concealed "were so patently material to the inquiry then being conducted that the documents containing them would have been marked had they been seen" by shareholders' counsel. (R. 289-290) Moreover, plaintiff's answers to the interrogatories were prepared prior to the testimony of Pomerantz and Graubard on the trial below that no IDS projections had been supplied to them. That subsequent testimony confirmed the obvious conclusion expressed in the Answer to Interrogatories.

In resting his case on a portion of Graubard's testimony, respondent:

> (1) ignores the testimony of Pomerantz, lead counsel for the original shareholders in the *Zenn* suits who testified flatly that he had never seen Pl. Ex. 245 for identification (R. 1121), or Pl. Ex. 246 for identification (R. 1136)*, nor had he ever seen any document containing the projections that appear in those two exhibits (R. 643-644). He recalled that Graubard requested projections and forecasts of David Wallace, Vice-Presi-

*These were the five-year and one-year projections described in Petitioners' Principal Brief (pp. 11-12).

dent of Alleghany at the time of the hearings, and that Wallace responded that there were no projections or forecasts of earnings and, hence, Wallace had never produced them (R. 641-642). Pomerantz had never seen the monthly Summaries of Operations for January, February and March 1950 (R. 1070, 1081, 1092), although he recalled having seen the detailed comparative balance sheets that were introduced and marked on the *Zenn* hearings as Exhibits 397-B-H (K. Exs. 178-84) (R. 644-647). Those balance sheets, of course, contained no projections whatsoever (R. 646);

(2) ignores Graubard's own testimony when confronted with an IDS projection for 1950. At that point, Graubard said, that if he had seen anything "which would indicate that the earnings would be so many times the sale [price] of the stock . . . I would have introduced it in evidence, had I known." (R. 401); and

(3) ignores the inherent impossibility that documents so richly promising to plaintiffs' case in establishing insider knowledge on the part of the self-dealing directors would have been overlooked by the array of meticulous, experienced legal talent engaged in "an exhaustive, sustained and detailed examination" (R. 1595) of the evidence bearing on the fairness of the settlement proposal.

The second proposition, that the concealed projections were cumulative, is based first on the erroneous assumption that this question does not raise a legal issue (Res. Br. p. 111, et seq.) and, second, on a misreading of the record.

As to the first error, the trial judge held that plaintiffs below had failed to show that the documents withheld would have "caused the referee to reach a different conclusion"

(R. 2325). Petitioners contend that the trial court's test was not the proper one. The Court of Appeals was sharply divided as to what standard should be applied to determine if the concealed documents were sufficient to set the settlement aside. That legal issue was briefed to the Court of Appeals by both sides. Petitioners' legal argument is found at pages 34 to 48 of their principal brief. Respondent, who has argued extensively as to the correctness of the trial court's legal test in his earlier briefs, has dropped all reference to that argument in an obvious effort to transform this issue into one of pure fact. But his ostrich-like refusal to face the issue, does not remove it from this case.

The legal issue as to the standard to be applied to the nondisclosed documents, like the related legal issue concerning the duty to disclose, is key to this case. Those legal issues are the ones for this Court. The determination of the factual issue, if one remains, is for the District Court. But that determination cannot be properly made until the correct legal standards are set forth.

As to the second error, respondent misreads the record when he states that there were "concurrent findings of fact" as to the documents in question. (Res. Br. pp. 64, 112).

There are no "concurrent findings of fact" as to the key documents. The most significant documents concealed were, of course, the IDS five-year projections for the years 1950-1954 (Pl. Ex. 245 *id,* R. 1121), the IDS projection for 1950, by months (Pl. Ex. 246 *id,* R. 1136) and the Wagg-Purcell-Young correspondence (Pl. Ex. 362 *id*—366 *id;* R. 1342-1360). All of these documents were excluded by the trial court because they could not be "tied" to Kirby. Therefore, they were not considered—and were not the subject of a finding—by the trial court when it concluded that the nondisclosed documents were not "of such significance that it would have caused the Referee to reach a different conclusion" (R. 2325).

It cannot even be argued that Judges Moore and Kaufman addressed themselves directly to the significance of all of the nondisclosed documents which were excluded by the trial court. Judge Kaufman, in reaching the conclusion that the nondisclosed documents were cumulative, addressed himself *only* to Exhibit 365 which showed a comparison of actual and projected income for 1950. He completely ignored the IDS projections for the years 1950 through 1954. Nor did Judge Moore specifically find that any of the projections beyond 1950 were cumulative of evidence before the Referee; rather, he borrowed the reasoning of the trial judge and excused their nondisclosure on the ground either that there was no showing that Kirby had personally received them prior to the exchange or, on the ground that counsel in *Zenn* had not been "precluded . . . from seeking any and all papers in the possession of IDS" (R. 2334-2335). Moreover, to state, as respondent repeatedly does, that petitioners have not argued that the "cumulative" findings, such as they were, are not clearly erroneous is utterly ridiculous (see Pet. Br. pp. 9 to 17 and 34 to 38).*

Respondent caps his attempt to minimize the importance of the concealed projections with an argument based on the assumption that petitioners' basis for attacking the validity of the IDS stock transaction rests on the dramatic rise in value of the IDS stock after the acquisition, rather than on

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*Indeed, the only evidence of any substance which respondent and Judges Moore and Kaufman could rely on as having been before the Referee was Purcell's letter of February 11, 1950 which discussed a prognostication made by IDS' mortgage department as to its earnings for the year 1950 (Pl. Ex. 345, R. 1186). As Judge Friendly has demonstrated, that letter is too thin a reed to support a finding that the concelead projections were cumulative (R. 2359-2360 and see Pet. Br. pp. 15-16). There is simply nothing in the *Zenn* record which revealed the information contained in the projections which covered the period beyond 1950. Such projections were concealed (Pet. Br. pp. 11-12).

the inside information as to projected earnings which was withheld during the settlement proceedings. (Res. Br. p. 137, et seq.)

This is, understandably, the most brightly colored of respondent's red herrings. It is absolutely necessary for him to divert attention from the existence of the inside information and its continued concealment. He does so by an elaborate dissertation on the economic climate and an analysis of the forces that drove our economy up. He then argues that the self-dealing directors had no inside information as to these factors or that such information was concealed. (Res. Br. p. 138)

Taking respondent's argument at its face value and assuming IDS stock rose in price because of "the long surge of economic expansion following the outbreak of hostilities in Korea in June 1950" (Res. Br. p. 138) and not the factors on which the concealed IDS projections were based, how does that excuse the non-production of those projections? If the projections did not exist or were unknown to the insiders before the transaction, then no cause of action could be maintained against those insiders, no matter why, or how high, the stock rose. But, the projections *did* exist, the insiders *did* have them, and those insiders *did* fail to advise the shareholders of what they knew. The transaction and the proxy material, therefore, was illegal regardless of what the economy subsequently did and regardless of whether those projections ultimately proved to be conservative in the light of facts not foreseen either by those who prepared the projections or the economic analysts quoted by respondent.

Petitioners do not complain of the IDS stock transaction because that stock eventually multiplied in value. They complain because inside information existed before that stock was taken and that inside information was not revealed to the shareholders. They complain because a claim based

upon that transaction was settled without disclosure of the evidence of that inside information to the courts. Nothing that has happened in the economy before or since that transaction can excuse those failures.

5. IN REPLY TO RESPONDENT'S POINT V

The argument in Point V is that there is no need for a rule requiring a defendant to search out and volunteer evidence because the case is based on deliberate deceit and because adequate remedies are available under state law.

The argument begins with the erroneous statement that the rule petitioners urge requires a challenged director to ferret out information (Res. Br. pp. 140, 152, 193).

While *one* of the theories urged below for imposing liability on Kirby can be read as requiring him to ferret out information, it was not the sole ground urged at trial or in the Court of Appeals. It is certainly not the ground urged here. Judge Friendly's dissent and petitioners' brief to this Court make clear that reversal does not require such a rule.

The thrust of respondent's argument here apparently is that the case does not belong in this Court—not that the result urged is incorrect.

While petitioners agree that New York common law would probably impose the same duty and hence yield the same result as the correct federal rule,* we do not agree that because the same result might be achieved under state

*The third question presented both in the petition for certiorari and in petitioners' brief raised the issue of whether the result urged here should have been reached under state law. In response to that question petitioners have argued that an alternative ground for reversal, in the event that this Court does not agree that federal law controlled, would be that the courts below erred in their application of state law (Pet. Br. p. 24). The petition for certiorari pointed out that even if this case involved no more than a decision on that alternative ground, it was a proper one for review in this Court.

law there is no need for a uniform federal rule. Moreover, because this case will set a standard of corporate behavior of nationwide importance, it is a proper one for this Court even if it involves only a question of state law (see Pet. for Cert. p. 24).

6. IN REPLY TO RESPONDENT'S POINT VI

Respondent's Point VI is directed at petitioners' Point I, which argues for the application of a federal standard here. Point VI begins with the erroneous contention that petitioners' Question No. 1 is "no more than an alternative formulation of Question No. 5" in the Petition for Certiorari (Res. Br. pp. 152, 158).

Respondent has chosen to equate Question No. 1 of petitioners' brief* with Question 5 of the petition for certiorari** because he finds it easier to argue the latter question. The equation allows him to argue, in response to Question 1, that the proposition advanced by petitioners "amounts to a claim that the existence of the Securities and Exchange Act made *Zenn* a nullity, to be ignored at will" (Res. Br. p. 158). But, that contention can only be applied to the argument that petitioners might have made under Question 5 of the petition. Under Question 5 it would be argued that the state court's exercise of jurisdiction was

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*"1. Where federal statutes (Section 14(a) of the Securities Exchange Act of 1934 and Rule X-14A-9) impose upon corporate directors standards of disclosure deemed necessary for the protection of the interests of shareholders, should a federal district court apply a comparable federal standard of disclosure in determining whether derivative actions alleging violation of those statutes have been fraudulently settled?" (Pet. Br. p. 3)

**"5. Did the state court have jurisdiction to authorize the settlement of the exclusive federal claim being asserted here? If not, can that court's approval of the settlement bar prosecution of that claim which is still pending in the federal district court?" (Pet. for Cert. p. 4)

erroneous and its judgment, no matter how perfect or how honestly achieved, is, therefore, a nullity.

The argument under Question 1 makes no such claim. It does not require a finding that the state court lacked jurisdiction and that the judgment was void for that reason. The argument proceeds on the assumption that the state court had jurisdiction and that its judgment, like any other judgment, might have res judicata effect. It contends, however, that the state court judgment should be set aside (or deemed not to bar a subsequent action) because it was fraudulently procured. Petitioners also argue under Question 1 that because the res judicata effect of the state court judgment, absent fraud, would bar prosecution of an existing federal action asserting a federal claim under § 14(a) (*i.e.* this action and *Zenn* federal), the criteria used in determining if a fraud had been committed should be found in federal law and should be consistent with the policy underlying the Securities Exchange Act.

Finally, petitioners argue, that in deciding what standards should be applied to determine if there was a fraud sufficient to prevent a state court judgment from disposing, by operation of res judicata or any other legal principle, of a federal claim in a federal action, this Court is not prevented from looking to federal law simply because the state court once held that the claim before it had a common law basis and that it therefore had jurisdiction. There is a vast difference between not being so bound and insisting that the state court judgment was a complete nullity, fraud or not. It is respondent's deliberate failure to recognize this difference that results in his equating the two questions.

The hinge of respondent's argument in Point VI is the contention that the settlement under attack here disposed only of a state court common law claim, and hence no problem of federal law exists. Examination proves that contention to be untenable:

(a) Respondent argues that the settlement attacked here did not involve a federal claim because there was no federal claim asserted in the state court action.

(b) Nowhere does respondent deny that a federal cause of action under § 14(a) exists in the underlying claim in this action or that it existed and still exists in *Zenn,* federal.*

(c) Respondent's principal defense to this action is that the state court settlement is res judicata as to the assertion of the § 14(a) claim asserted here, in *Zenn,* federal, or in any other action pleading a violation of § 14(a) based on the IDS stock transaction.

(d) Petitioners urge, therefore, that if respondent's defense to this case is correctly conceived, and that, absent fraud, the state court settlement is a bar to the assertion of a federal claim on the same facts, then this Court must test the validity of that settlement by federal standards.

(e) If, on the other hand, the argument respondent seems to be making in Point VI is correct, i.e., that the state court judgment did not dispose of, and does not bar a federal claim, then there should be no bar to the assertion of the underlying claim in this action, or to the prosecution of *Zenn,* federal.

Woven into Point VI are other distortions of the issues:

(a) Respondent erroneously states that petitioners' position requires a finding that the Securities Exchange Act pre-empts the entire field of corporate law and regulation (Res. Br. p. 159, et seq.), and that "corporations within any part of the jurisdiction of the SEC for any purpose become completely subject to a new and uncodified federal common law of corporation." (Res. Br. p. 162)

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*The basis for personal jurisdiction over Kirby in *Zenn,* federal, was the extraterritorial service provision of the Securities Exchange Act. Kirby was served under that provision, he appeared and never challenged the federal court's jurisdiction.

Petitioners have expressly disavowed that position:

> "We do not suggest, of course, that this is an area where the legislature has given a mandate co-extensive with that embodied in, for example, federal labor legislation, and that federal courts must create a corpus of law for the entire field which state courts would be bound to follow." (Pet. for Cert. p. 17)

But petitioners did urge, that operating, as the federal courts are in this case, in the penumbra of federal legislation and in an area where the issues transcend local considerations, federal courts should apply federal law (*ibid.*).

It is simply not necessary to argue, or for this Court to find, that federal law occupies the whole field of corporate law.

(b) Respondent erroneously states that petitioners contend reversal should be had "because the court below failed to apply § 14(a) as a rule of federal practice to determine when federal courts should allow collateral attack for fraud." (Res. Br. p. 168)

Petitioners' position is: § 14(a) of the Securities Exchange Act of 1934 imposes a duty of full disclosure. To effectuate the purpose of the Act, and in particular the purpose of § 14(a), comparable disclosure standards must be applied when determining if a settlement disposing of a § 14(a) claim has been fraudulently obtained.

Petitioners have made clear the relevance of § 14(a) to their argument:

> "While the duty to disclose in litigation and the consequences of non-disclosure are not found in the words of § 14(a), they are found in the policy of the statute and are rooted in the necessity that the courts adopt rules which will further that policy. Hence, it

> can be said that the rule proposed here is implied in the statute.
>
> "But, it is, of course, not necessary to find the duty to disclose prior to settlement and the consequences for breach of that duty either explicitly set forth or implied in the statute. It is sufficient that the rule proposed here is necessary to give effect to the statute's purpose." (Pet. Br. p. 28)

Thus, petitioners are not asking for "an extension of the scope and coverage of the Securities Exchange Act" as respondent claims (Res. Br. p. 176). but merely for a rule consistent with the policy of that Act.

Petitioners have never called for the application of § 14(a) by this Court or the court below. On the contrary, they have explicitly stated:

> "It is not our contention that the federal courts must necessarily apply precisely the same standards found in the statute. We do say, however, they should apply standards consistent with the statutory purpose. In doing so the courts may look to the statute, they may look, as Judge Friendly did, to federal cases such as *United States* v. *Consolidated Laundries,* 291 F. 2d 563 (2d Cir. 1961) or to *Hewitt* v. *Hewitt,* 17 F. 2d 716 (9th Cir. 1927) or even to state law. See *e.g. Meinhard* v. *Salmon,* 249 N. Y. 458 (1928). But, wherever they look, they must find and apply rules which will not frustrate the purpose of the statute." (Pet. for Cert. p. 18)

(c) Respondent erronously states that petitioners contend the New York court should have applied § 14 and that "the New York courts' (sic) failure to apply § 14(a) of the Securities Exchange Act as the standard for measuring

Kirby's burden in *Zenn* was not error, but 'fraud' . . ." (Res. Br. p. 154).

Petitioners have never contended that the New York court should have applied § 14(a), or even that the courts below should have applied it. They have only said that in deciding if the assertion of a § 14 claim in a federal court is now barred, because a similar claim had been settled in a state court, federal standards consistent with the policy underlying § 14(a) should be applied.

The assertion that petitioners contend that the state court's failure to apply § 14 was the fraud complained of, is a glib attempt to shift the onus of the improper settlement *from* the insiders to the court. The fraud upon which this suit is based is the concealments of the insiders. Petitioners have not suggested that the state court was in error and hence there is no basis for stating that they are attempting to transform that "error" into a fraud sufficient to support a collateral attack. On the contrary, petitioners' brief makes clear the state court was a victim of the fraud.

7. IN REPLY TO RESPONDENT'S POINT VII

Respondent's Point VII builds on his Point VI; it assumes the absence of a federal question and argues that state law should apply.

Even if we accept both the assumption and the argument, reversal is still required. Petitioners' brief has shown that it appears that the state law would impose the same duty of disclosure which is necessary under federal law (Pet. Br. pp. 31-32). That brief also shows that under proper application of the common law intrinsic-extrinsic fraud doctrine, the fraud here is sufficient to set aside the settlement. This conclusion has also been reached in a recent Yale Law Journal Note dealing with the *en banc* decision in this case, 74 Yale L. J. 1140 (1965).

8. In Reply to Respondent's Point VIII

In Point VIII Kirby argues that the application of the rule proposed by petitioners would be unfair and impractical in future cases. Earlier he argued that the application of the rule in this case would be unfair as to him.

The unfairness to him, he contends, lies in forcing him to try the merits of the IDS stock transfer so long after it occurred.* The argument has little appeal even if, after the decision of the Second Circuit, a trial of that issue is needed. Kirby forgets that it was his co-fiduciaries who by their concealments prevented a trial on the merits from occurring at the conclusion of the hearings before the Referee. He also forgets that he engineered his settlement of the IDS claim in 1959. Had those concealments or the settlement not occurred, a trial on the merits could have taken place.

He also complains because the issue was not tried below. But again that was his doing. Plaintiff below urged the trial court that both the fraud and the underlying IDS claim *had* to be tried together. The issue was briefed to that court. It was Kirby's opposition that resulted in the ruling which prevented a trial on the merits below.

The self-dealing directors—including Kirby—have waged a persistent battle, in which nothing has been spared, to prevent a trial on the merits. Indeed, Kirby's opposition to petitioners' intervention was no more than another of the strenuous efforts to keep the issue from the courts. Hence, his complaint that it would be "unfair" to try the issue now, comes with exceedingly ill grace.

The charge that the rule urged would work mischief in future cases is, of course, the last resort of all those who

*He points to the death of Young as the only specific example as to why it would be difficult to try that issue. But Young was dead months before the 1959 settlement. Even if the issue had been tried then it would have been without Young.

desire to sway the court from a just result in the case before it. Moreover, the charge is without merit. It attacks a rule not proposed and not needed in this case. Therefore, the results it foresees, even if accurate, are not the consequences of the rule required here.

Respondent bases his Point VIII argument on a rule that would require a director to ferret out and introduce evidence seen but overlooked by shareholders' attorneys. Those are not the facts of this case. On the facts here this Court need only find that a federal court is not bound by a settlement of a § 14(a) claim where self-dealing director-defendants have failed to disclose fully in the face of specific demands for the concealed evidence. Respondent's parade of horrors is simply marching down the wrong street.

Nor is there any merit in respondent's contention that the rule is somehow inconsistent with the adversary system. The persistence of a fiduciary duty in litigation has been recognized not only in the trustee cases (Pet. Br. p. 31) which respondent attempted to distinguish, but in stockholder derivative actions which he did not mention. *Heddendorf* v. *Goldfine,* 167 F. Supp. 915 (D. Mass. 1956). Compare, *Masterson* v. *Pergament,* 203 F. 2d 315 (6th Cir. 1953); see: *Cohen* v. *Young,* 127 F. 2d 721 (6th Cir. 1942).

Finally, the rule proposed does not prevent a director from defending himself. The issue is not whether a director can defend himself, but whether he should be allowed to keep the benefits of a settlement without disclosing the relevant information. Of course a director has the right to defend, but only on a record which includes all relevant facts. If these facts do not easily lend themselves to a defense or if, as here, they allow no defense at all, it is the

self-dealing director, not the minority shareholders, who should bear the loss.

CONCLUSION

For the foregoing reasons the relief requested in the Brief For Petitioners should be granted.

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Respectfully submitted,

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